Middle Market Overview

March 2013

Sankaty
ADVISORS

Overview of Middle Market

We view the middle market as having three distinct segments, defined by a company's ownership type, prospects, and access to capital. Companies with EBITDA below about $10 million (lower middle market) are typically family or entrepreneur owned and individual customer wins and losses greatly impact performance. Many of those sales relationships are concentrated in the family, and senior management ranks are often populated with family members. Such companies are generally well served by local banking relationships, government-sponsored entities such as Small Business Investment Companies (SBICs) in the U.S., or public entities such as Business Development Corporations (BDCs). Sankaty plays in this segment very selectively.

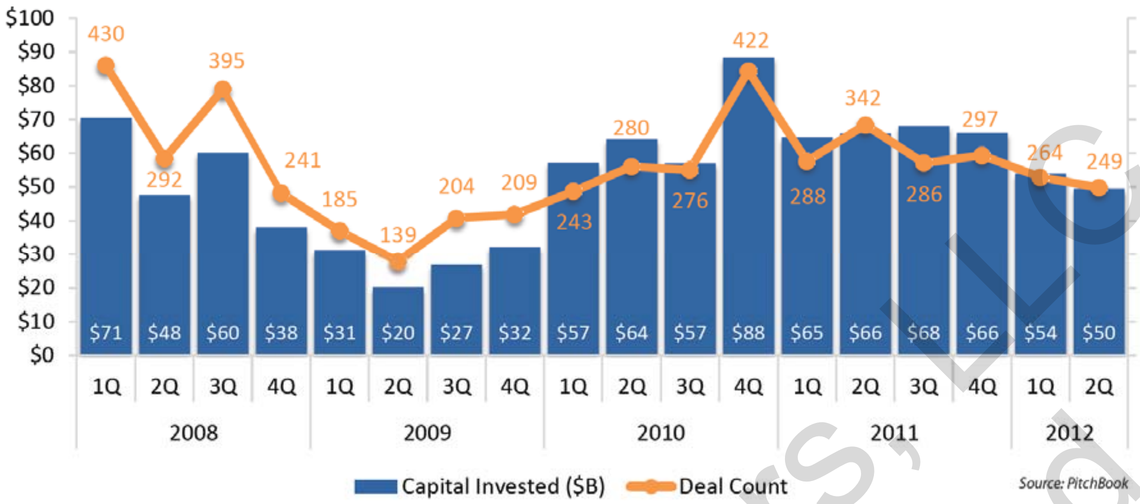
At the other extreme, upper middle market companies typically have $75 million of EBITDA or more, and are often publicly held or sponsor backed. These companies, given their size, typically ebb and flow with their respective industries. They have myriad options for accessing capital, notably including the public high yield market. Some institutional investors who are looking to write large checks ($100 million or more) also participate in this space, though volume is limited. Given the relatively lower yields in this segment, as well as structural disadvantages such as the lack of maintenance covenants and limited information rights, Sankaty also only plays selectively in this segment.

We define the core middle market as companies with $10 to $75 million of EBITDA and this is the segment where we are most active. Companies are typically sponsor owned with several opportunities for growth, from taking share to expanding into related products or new geographies. Our industry teams are crucial to evaluating such companies' prospects, and our sourcing efforts generate many opportunities here annually as the financing options (including stand-alone mezzanine firms and insurance companies who do not raise outside capital) are very disparate in this segment.

Size of Middle Market

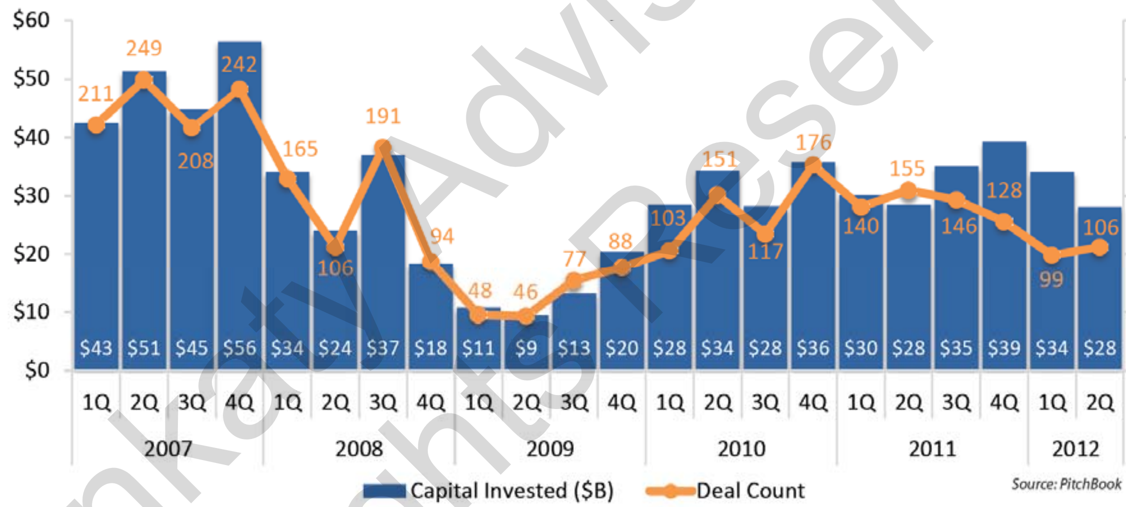
A source of data that provides a fairly comprehensive snapshot of the U.S. middle market activity over the past several years is *Pitchbook*. Please note that the data refers to total enterprise value and not just loan value. Assuming that the majority of transactions include an equity component of approximately 30 to 50% of total enterprise value, the loan component of the market is approximately 50 to 70% of the amounts shown. It should be noted that *Pitchbook* defines the middle market as companies with total enterprise value between $25 million and $1 billion and the “core middle market” as between $100 million and $500 million. Based on this data, as an example, the estimated size of the loan market for the “middle market” and the “core middle market” in 2011 would be approximately $160 billion and $75 billion, respectively. Assuming that mezzanine typically equals approximately 15% of the capital structure, the total mezzanine middle market is equal to about $24 billion, plus additional amounts for unsponsored situations.

Figure 1: Middle Market – Deal Flow by Quarter



Source: *Pitchbook*, 2H 2012 Middle Market Report.

Figure 2: Core Middle Market – Deal Flow by Quarter



Source: *Pitchbook*, 2H 2012 Middle Market Report.

Middle Market Structure and Terms

Middle market loans fall into one of two broad categories. First, a number of middle market loans are in the form of senior debt instruments. The majority of these loans are protected by collateral and can be in the form of asset-based revolving lines of credit or first and second lien loans. Collateral for these loans typically includes all assets of the borrower such as receivables, inventories, plant and equipment (unless there is equipment financing in place), real estate (unless specifically carved out as collateral for mortgage loans), and any intangibles such as trademarks and customer lists. The second broad category consists of mezzanine loans which typically do not have any hard collateral but are instead protected by the cash flow of the issuer. Both types of loans typically include a pledge of stock as collateral with senior loans in a first position. Middle market loans also benefit from a full set of maintenance covenants, which can include restrictions on leverage levels, interest coverage, etc. Middle market loans also generally give lenders more access to company information such as monthly financials and board observations rights. Because middle market deal terms are customized between lender and creditor, middle market lenders have better information rights and protective covenants than a broadly syndicated loan or bond. While general terms can ebb and flow to some degree with the market environment, we believe the below table from Lincoln International provides an accurate snapshot of current pricing terms for middle market deals.

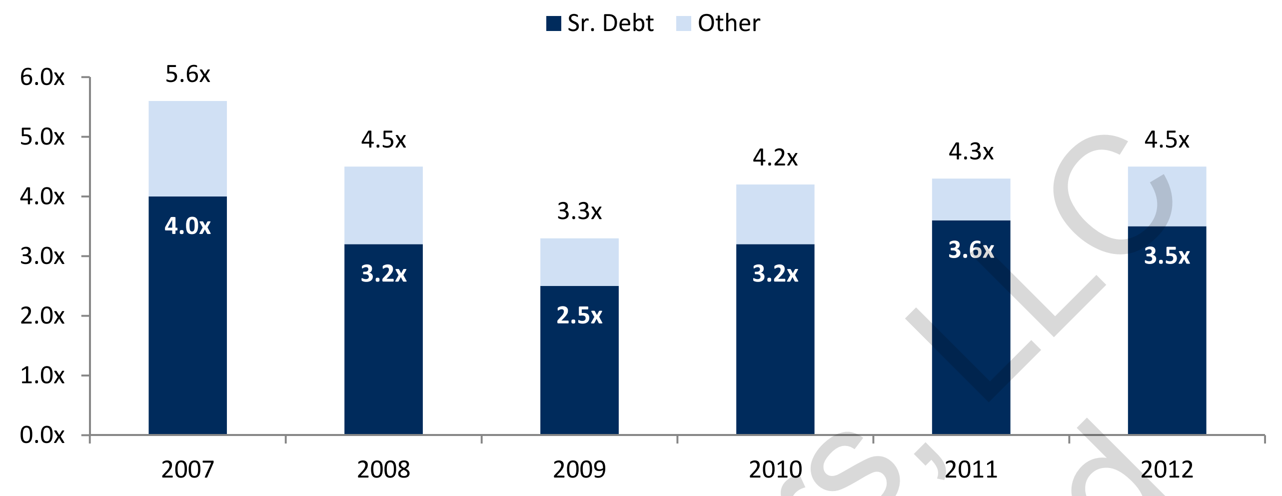
Figure 3: U.S. Middle Market Pricing & Terms

	Borrowers with at least $15M EBITDA	
	Pricing	**Multiples**
Cash Flow Senior	– L+475 – 574 – LIBOR Floor: 100 -150	– 3.00x – 3.50x EBITDA
Unitranche	– L+750 – 850 – LIBOR Floor: 150	– 4.00x – 5.00x EBITDA
2nd Lien Loans	– L+900 – 1100 – LIBOR Floor: 200	
Sub Debt	– Cash of 11.0% - 12.0% – PIK of 1.5% - 2.5% – All-in of 12.5% - 14.5%	
Equity	– n/a	– Approximately 35%

Source: Lincoln International.

Average middle market total leverage levels tend to range between 3.5x and 5.0x versus enterprise values ranging from of 6.0x to 8.5x. Consequently, the loan to value would equate to 50 to 70%. Figure 4 provides an illustration of typical middle market leverage levels over the last six years. While leverage levels have increased a bit over the last two years, they are still well below levels reached prior to the credit crisis. Depending on the size of the company, stability of earnings and industry, there can be considerable variation in leverage levels. Certain industries such as tier two auto suppliers or distributors might justify total leverage below this range for first lien notes while certain segments such as subscription-based software providers might warrant higher leverage. Our industry groups are instrumental in guiding us to the appropriate risk/reward trade-offs across the spectrum.

Figure 4: Middle Market Leverage

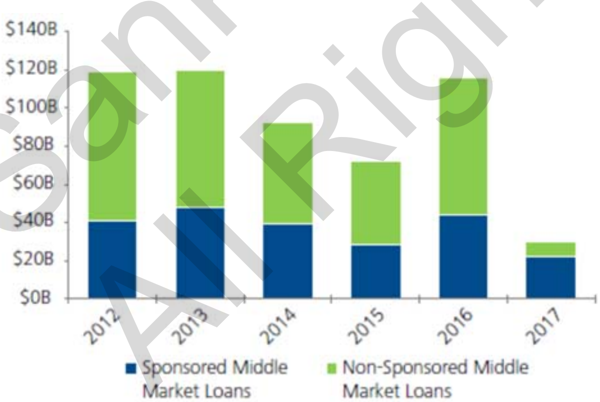


Source: Standard & Poor's Leveraged Commentary and Data.

Middle Market Maturity Wall

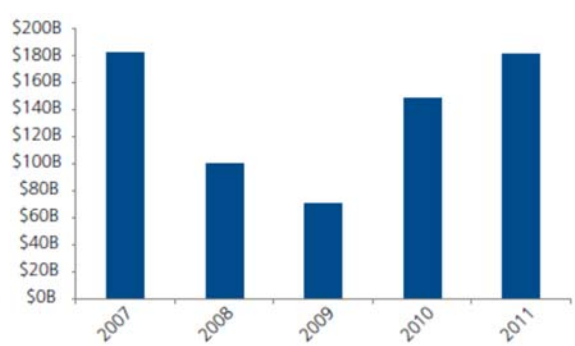
The maturity wall through 2017 for pro rata and institutional middle market loans is shown in Figures 5 and 6. As illustrated in Figure 5, there is a dip in loans maturing during the 2014 to 2015 period. This directly corresponds to the lower new volume activity that was experienced in 2008 and 2009 as a result of the recession (as can be seen in Figure 6). These charts also show that a rebound in new loan activity starting in 2010 is driving a corresponding increase in expected loan maturities beginning in 2016. Our expectation would be for 2017 to show similar levels once the most recent year of new loan volume has been included in the data. We believe that the combination of new deal activity stemming from both change of control transactions and refinancings at maturity will create ample opportunities for investors over the next five years and beyond.

Figure 5: Middle Market Loan Maturities



Source: Thomson Reuters LPC, The Road Ahead: An Update Maturity Wall, Deloitte, March 2012.

Figure 6: New Issue Middle Market Loan Volume



Source: Thomson Reuters LPC, The Road Ahead: An Update Maturity Wall, Deloitte, March 2012.

Middle Market Default and Recovery Rates

In our experience, mezzanine investors typically have more control in an investment than a high yield investor. First, in a mezzanine deal there are traditionally one or two investors whereas with high yield, it is not uncommon to have more than 10 investors in large syndicated deals. With one or two investors, mezzanine lenders can control the tranche, force action, and make decisions to control the outcome of the investment. With more investors, because no one party can control the group, decisions often take longer and this delay erodes value.

Second, in our experience, middle market mezzanine lenders typically have a more active role in monitoring investments than high yield lenders. Mezzanine lenders have greater information rights than investors in large syndicated deals. These include monthly financial reporting packages, monthly performance calls, and direct access to all levels of management. Further, tighter covenants as noted previously, imply mezzanine investors can control decisions early in a downside scenario. By taking action early, middle market mezzanine lenders are able to preserve value and improve recovery rates.

Because the covenants in the mezzanine market are tighter than in high yield, default rates are higher in mezzanine. Given this dynamic, we believe that recovery rates are the critical statistic for investors to consider when evaluating mezzanine asset managers. Over Sankaty's fifteen-year history of mezzanine investing, the average default rate experienced in our mezzanine portfolio is 8.2% annually, versus the high yield market default rate of 3.4% over the same period.[1] However, defaults in the Sankaty mezzanine portfolio recovered 94 cents on each defaulted dollar relative to 39 cents over the same period in the high yield market.[2] Using these statistics, the implied loss ratio per annum (calculated as annual default rate multiplied by 100 minus the recovery rate) is 0.5% in the Sankaty mezzanine portfolio versus 2.1% in high yield. The lower loss ratio in our mezzanine portfolio compared to high yield is a direct result of the level of control paired with our active management of mezzanine positions. Importantly, this annual loss ratio would be applied to a 15 to 20% return range in mezzanine investments, relative to a 7 to 10% return range in high yield.

We believe that driving high recoveries is a critical driver of outperformance of mezzanine asset managers. Sankaty's 94 cent average recovery over the last 15 years compares with the 46 cent recovery of the broader mezzanine universe, according to CEPRES data which aggregates the deal level performance of 250 mezzanine funds.[3] In our experience, successful mezzanine funds are often able to achieve a higher recovery rate because of the turnaround work of in-house portfolio groups with deep operational expertise. These teams can quickly enter a situation to drive operational changes that improve business performance and returns. Borrowed from the private equity portfolio

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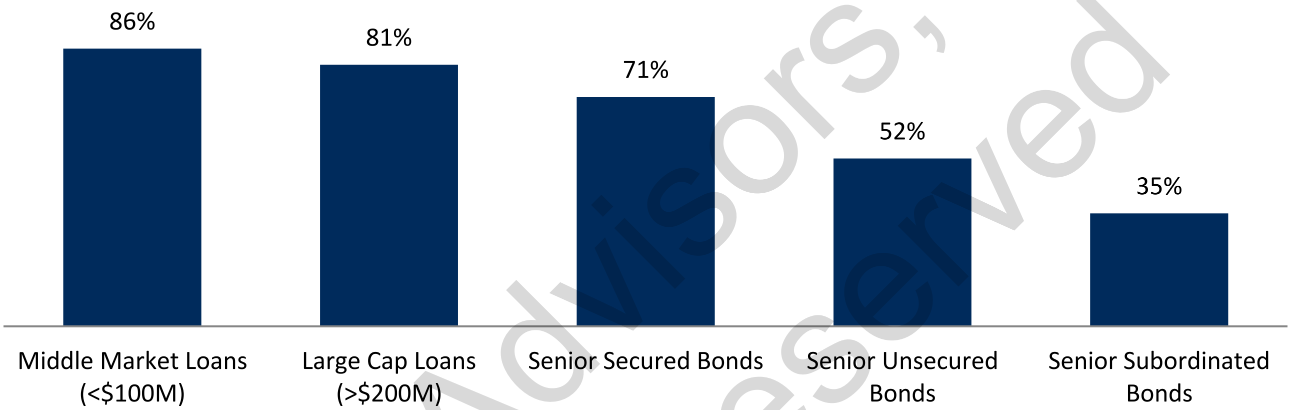
[1] Sankaty analysis as of September 30, 2012 and JP Morgan Default Monitor as of December 31, 2012.
[2] Sankaty analysis as of September 30, 2012 and JP Morgan Default Monitor as of December 31, 2012.
[3] Sankaty analysis as of September 30, 2012 and CEPRES Mezzanine Market Report as of September 30, 2012.

group model, the inclusion of operation professionals in the deal process also allows such mezzanine managers to invest more wisely and improve the outcome of investments.

We also show a comparison of recovery rates across loan classes from the S&P LSTA (Figure 7), which demonstrates variation across capital structure and across market capitalization. Of note, we find it compelling that the average recovery rate for mezzanine middle market loans (47% per CEPRES) is significantly higher than the 35% recovery rate for broadly syndicated, liquid high yield bonds. It is important to note that the mid-market loans bar only refers to senior loans, which have a very different risk/return profile than mezzanine.

Figure 7: Recovery Rate by Loan Class



Source: S&P/LSTA. Ultimate recovery rates for the period 1989 to 2009.

Middle Market Loans: Breakdown by Investors and Purpose

Breakdown by Investor Type:

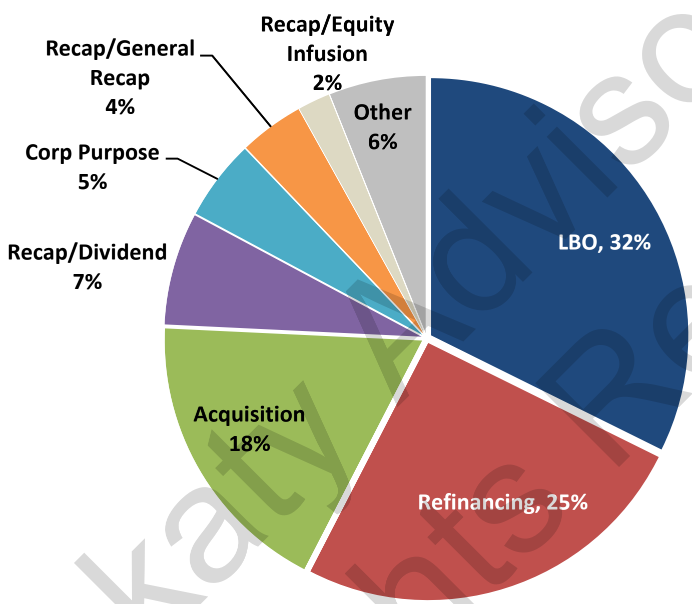
As shown in the Figure 8, domestic banks while still a large and important part of the market, have played a smaller role than they had in previous years. Institutional investors have notably picked up most of the slack created by this trend. Finance companies and foreign banks also continue to play a material role in the market. We would like to point out that this particular data table is from the *S&P Capital IQ Q4 2012 High-End Middle Market Lending Review* and represents data collected from a subset of the universe of market participants, but in our view represents a reasonable gauge to monitor trends around investor type within the market. Also, from the same S&P Capital IQ source and with the same caveats as noted above, Figure 9 shows a breakout of the loan purpose for the sample set from 2012. The three largest categories include LBO (change of control buyout transactions), re-financings, and add-on acquisition support.

Figure 8

Middle Market																
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Domestic Bank	36.8%	40.0%	46.6%	53.6%	59.9%	52.2%	28.0%	13.0%	13.0%	15.8%	7.4%	14.8%	26.0%	16.0%	19.8%	12.2%
Finance Co.	7.6%	8.8%	11.8%	16.2%	17.7%	24.8%	39.5%	13.5%	11.0%	17.1%	13.0%	38.9%	34.8%	20.9%	22.6%	20.8%
Foreign Bank	25.1%	23.9%	18.1%	14.9%	16.0%	16.5%	6.5%	5.7%	6.9%	5.5%	6.8%	15.7%	6.3%	12.5%	9.6%	10.3%
Institutional Investors	25.7%	22.2%	19.9%	12.7%	3.8%	3.0%	25.6%	67.4%	64.7%	57.6%	67.2%	29.4%	30.3%	48.6%	45.5%	56.8%
Securities Firm	4.9%	5.0%	3.6%	2.6%	2.5%	3.5%	0.4%	0.3%	4.3%	4.1%	5.7%	1.2%	2.6%	2.0%	2.5%	0.0%

Source: S&P Capital IQ, Q4 2012 High-end Middle Market Lending Review.

Figure 9: Total New-Issue Volume ($9.88B)



Source: S&P Capital IQ, Q4 2012 High-end Middle Market Lending Review.

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